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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

The West German Economy on the Eve of the Nixon-Brandt Meeting

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
December 1971

INTELLIGENCE MEMORANDUM

THE WEST GERMAN ECONOMY ON THE EVE OF THE NIXON-BRANDT MEETING

Conclusions

1. The immediate impact of the 18 December currency realignment on the German economy will be a psychological boost to business confidence resulting from settlement of the international monetary crisis. The December settlement means a somewhat smaller average appreciation of the deutschemark than had already occurred on the market. It provided for a somewhat higher dollar-deutschemark rate than had been anticipated, but it reduced the deutschemark revaluation vis-a-vis the currencies of the major European countries, which account for two-thirds of German exports. On the average the deutschemark will appreciate 6%-7% relative to all other currencies.

2. The West German economy, basically the strongest in Europe, currently is experiencing a marked slowdown -- precipitated by the government's anti-inflationary policies – together with an intolerably high rate of price increase. Business confidence has been eroded by lagging domestic and foreign sales and fears of the adverse effects of the deutschemark revaluation Unemployment remains a minor problem thus far but is rising.

3. The key consideration affecting the short-term economic outlook is the timing of a change to an expansionary monetary and fiscal policy. Although sensitive to the danger of recession, the government is unwilling to reverse its restrictive policies until inflation has been brought under control. In the absence of reflationary measures, real gross national product (GNP) in 1972 probably will grow no more than 1%.

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

Discussion

4. At the end of 1971, West Germany is beginning to exhibit symptoms of the economic malaise so aptly described as "stagflation." Although real GNP has declined since early spring, the surge of inflation continues. The overall level of business activity remains high, but order backlogs are dwindling. Despite some moderation of wage pressures and price declines for industrial producer goods, inflation has accelerated. The cost of living in October 1971 was a record 6% higher than a year earlier, an increase alarming to those who recall the runaway inflation in the 1920s and late 1940s. The reestablishment of fixed exchange rates and elimination of the uncertainty that dominated international trade and finance through most of 1971 should provide some stimulus. Business and labor are increasingly worried about a recession in 1972. Looking ahead to the election campaign in 1973, however, government leaders still see inflation as their principal concern.

Production and Investment

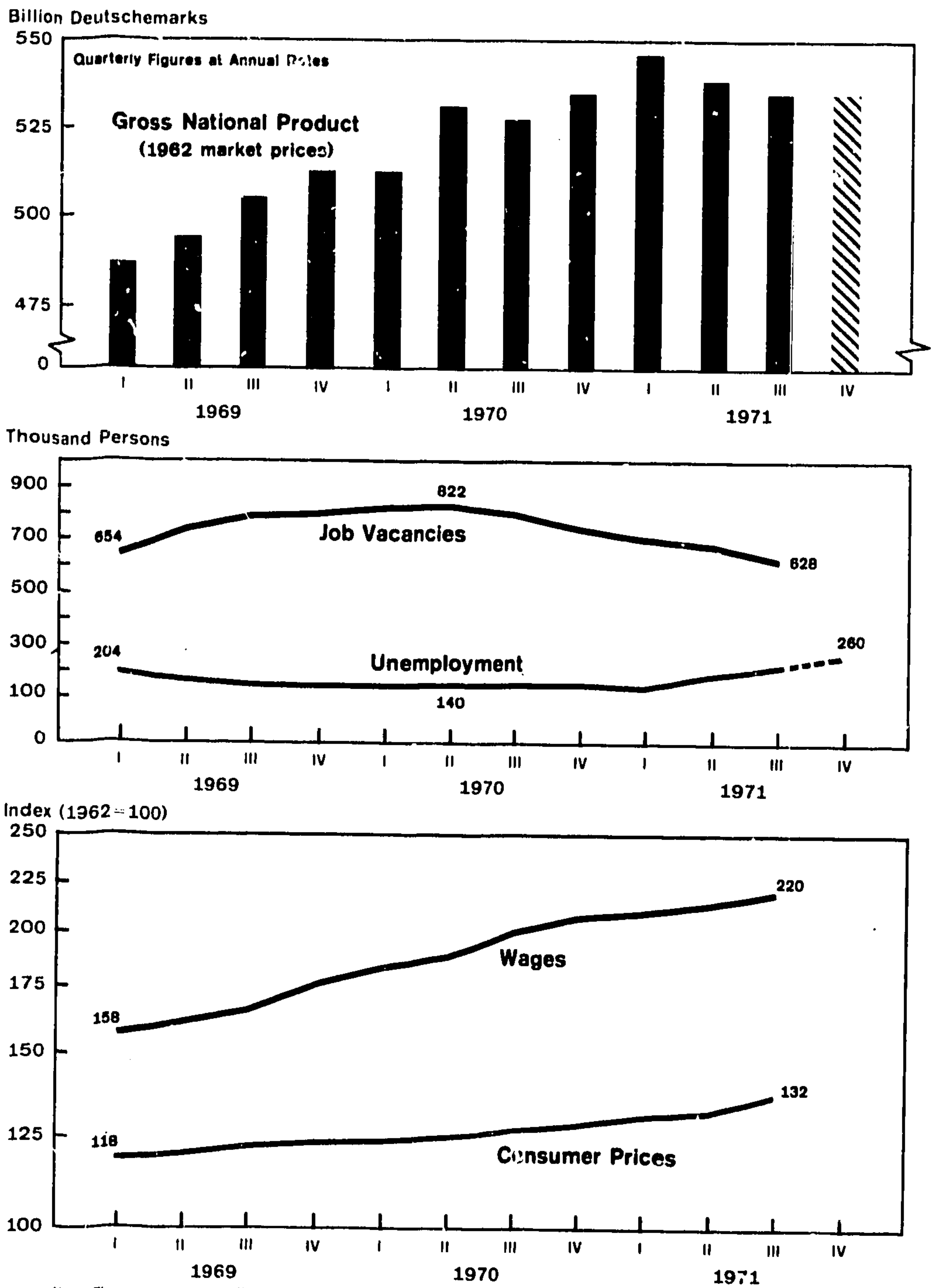
5. The growth of real GNP in 1971 is expected to be no more than 2% to 3%, substantially less than the 8.0% and 5.4% achieved in 1969 and 1970. Indeed, the aggregate output of goods and services has declined during the year. By the third quarter, GNP was 2% below the first quarter's level, primarily because of declines in exports and gross fixed asset formation (see Figure 1). Underlying the decline in GNP was a marked slowdown in industrial growth – especially in the capital goods sector, which accounts for 40% of output and 60% of exports of manufactures. The overall increase in industrial production in 1971 probably will be no more than 2% – far less than the 13% attained during the 1969 boom and even the 6% gain in 1970.

6. Demand pressures have eased noticeably throughout the economy. Investment in new plant and equipment has dropped off sharply. Industrial investment plans reportedly were radically revised downward, apparently because of shrinking profits and the business community's growing pessimism regarding the near-term outlook. Heightening concern among businessmen over the effects of the new US economic policy and over government plans to raise corporate taxes and increase labor participation in management have contributed to the worsening investment climate.

7. Rapidly rising production costs have cut deeply into profit margins, reducing firms' ability to finance investment from retained earnings. At the same time, borrowing costs remain high, and businessmen are having difficulty refinancing the large volume of short-term debts incurred in the

West Germany: Selected Economic Indicators

Figure 1



Note: Figures are seasonally adjusted.

512745 12-71

past few years with cheaper, longer-term credits. Profits have been squeezed further because German export industries have had to absorb at least part of the cost increase for foreign buyers resulting from the deutschemark's revaluation since May.

8. Although many German producers have cut their prices to remain competitive in foreign markets, export growth has declined. Slack foreign demand and the investment slump have forced some industries to curtail production and employment. The resulting psychological impact -- which is out of proportion to the actual wage loss -- has put a damper on consumer buying. In recent months there has been a pronounced slowing of the growth of retail sales, the economy's most buoyant factor since mid-1970.

9. The value of new orders placed with manufacturing industries has remained below sales since May, and in recent months has actually declined. The decline -- especially sharp for capital goods -- is attributable primarily to the worsening investment climate. Exports orders also have fallen off. It is too early to tell whether this reflects a deteriorating competitive position attributable to the deutschemark's appreciation during 1971 or to the concentration of export orders early this year, when foreign customers widely anticipated revaluation. The adverse impact of shrinking order books on business confidence is aggravated by the fact that manufacturing capacity expanded more than 20% during the recent boom. Utilization of plant capacity in October was down to 85%, approximately the level in the fall of 1966 at the onset of Germany's worst postwar recession.

The Labor Situation

10. The labor market is beginning to develop some slack as a result of the gradual business slowdown. Total employment has declined slightly since early summer, more as a result of attrition than layoffs. Officially registered job vacancies show a larger decline, auguring a further reduction in labor demand. Unemployment, however, is still only a minor problem. Although the number of unemployed in October 1971 was up sharply from a year earlier, it approximated only 0.8% of total wage and salary workers.

11. Employment cutbacks have occurred primarily in manufacturing -- particularly in the machine building, electronics, and iron and steel industries, where shorter work weeks are becoming more widespread. Employment in trade and other service activities, however, was still expanding in late summer. This has cushioned layoffs in industry and also explains in part the continuing, if much reduced, increase in employment of foreign nationals.

12. Growing slack in the labor market is dampening new wage increases. The rapid growth in hourly earnings in 1971 is traceable largely

to pay hikes granted in 1969-70, when labor's bargaining power was stronger and management was able to compensate for higher labor costs by raising prices. But wage increases are slowing down: hourly earnings in the third quarter of 1971 were only 12% above those a year earlier, compared with a 16% rise between the corresponding periods of 1969 and 1970. Recently negotiated wage settlements have provided for increases in basic rates averaging 8% to 9%. Although these still somewhat exceed the government's guidelines, they are substantially below the 12% to 14% settlements not uncommon at the boom's height in 1969. Cutbacks in overtime are also reducing the growth in average hourly earnings.

Price Trends

13. Price movements have been mixed since mid-1971. Price rises for industrial producer goods have come to a virtual halt, as expected early in a cyclical downswing, but cost of living increases have accelerated. Cost-push pressures have moderated in many industries. The increase in labor costs has slowed down and, because of the appreciation of the deutschemark, the cost of imported raw materials has declined. At the same time, with both domestic and foreign demand easing (particularly for capital goods), competition has forced producers to absorb cost increases.

14. As elsewhere in similar circumstances, cost-push pressures appear to be moderating less in services than in industry. The prices of most services, especially repairs and rentals, are still rising very rapidly and remain the major factor in the growing cost of living.

15. Because of continuing inflationary pressures, the government thus far has not expressed undue concern over the gathering signs of economic slowdown. In fact, it has deliberately followed deflationary policies, including the float and budgetary curbs postponing reform programs crucial to labor's continued support. In a speech before the Federal Employers Union on 7 December, Economics and Finance Minister Schiller reaffirmed the government's determination to reduce inflation to acceptable levels. He emphasized that the government's freedom to stimulate the steadily weakening economy depends on labor and management following responsible wage and price policies. Bonn believes that contractual wage increases should be held to no more than 6%, approximately in line with anticipated increases in labor productivity. If this result can be achieved, the government will feel free to use contingency funds to stimulate economic activity.

The Foreign Sector

16. West Germany's foreign economic position is the strongest in Europe, and its foreign exchange reserves are the world's largest. Despite

the 9.3% revaluation of the deutschemark in October 1969, export growth was rapid throughout 1970 and only recently has begun to level off.* The value of imports has grown somewhat less rapidly than that of exports, reflecting their lowered cost (in terms of deutschemarks) since the deutschemark's appreciation and, in recent months, the decline in aggregate domestic demand. The trade surplus averaged roughly $4 billion annually in 1967-70 and probably will approximate that amount in 1971 (see Figure 2).

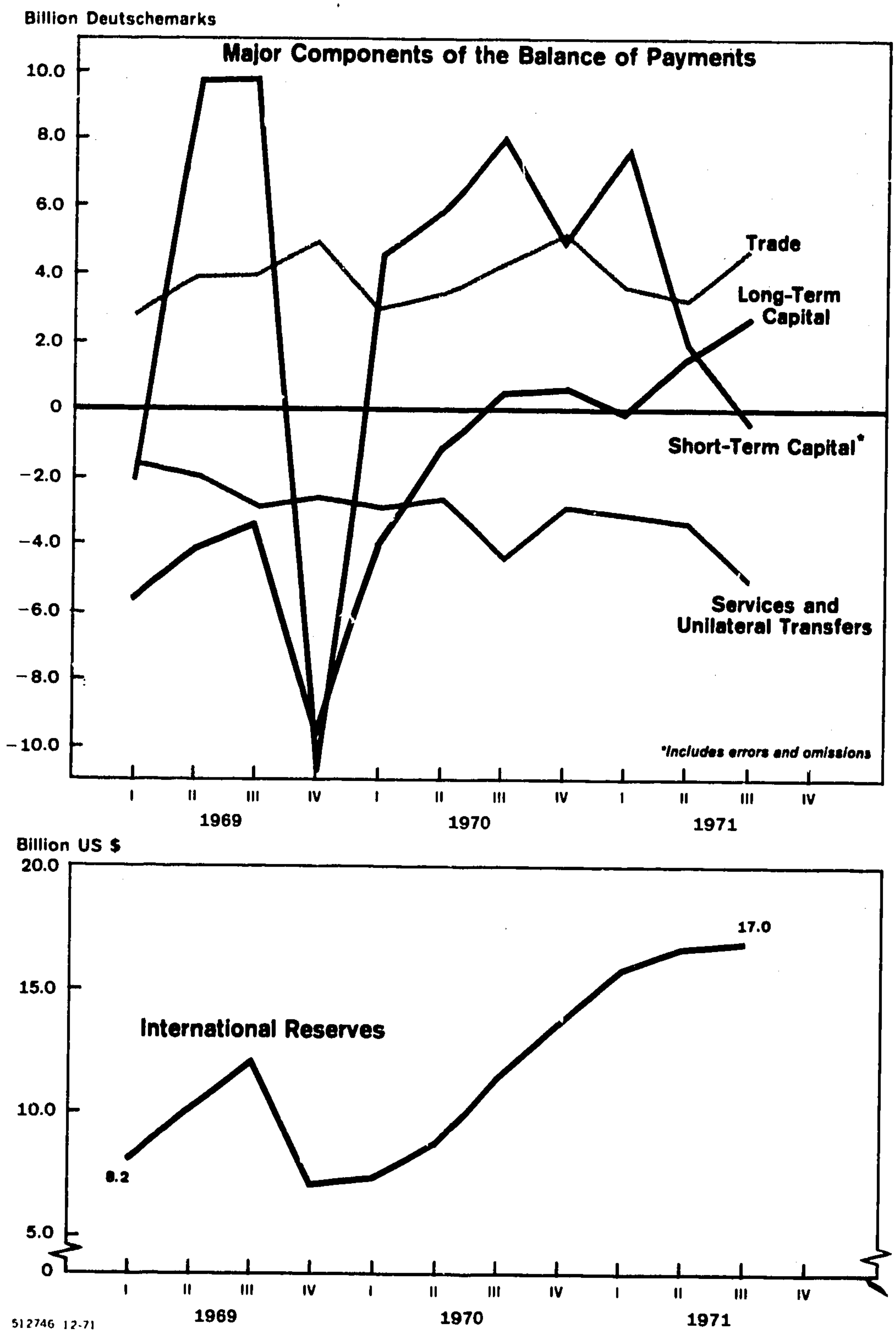
17. The trade surplus, however, has been increasingly offset by a rapidly increasing deficit in services and transfer payments. Reflecting the prosperity of the past few years, German tourist expenditures abroad have soared, and foreign workers' remittances have climbed at an unprecedented pace. As a result, the current account surplus declined from nearly $2 billion in 1969 to less than $700 million in 1970, and a further decline is likely in 1971.

18. In the late 1960s, West Germany became a major net exporter of long-term capital. Net long-term capital exports reached a record high of some $6 billion in 1969. As the Bundesbank imposed increasingly restrictive monetary policies in 1970, the domestic capital market tightened severely, cutting the net outflow of long-term funds to $1 billion. In the first nine months of 1971, West Germany experienced a net long-term capital inflow of more than $1 billion because of a further decline in German long-term lending abroad and increased placement of foreign long-term funds in West Germany. The latter flows undoubtedly were motivated to some extent by the desire to profit from deutschemark revaluation, a dollar devaluation, or both.

19. Short-term capital inflows have been highly disruptive in the past few years, largely vitiating the Bundesbank's attempts to restrain inflation through restrictive monetary policies. The large increases in German interest rates relative to those in other major money markets inevitably attracted large inflows of short-term capital. These inflows assumed massive proportions once speculation was rife that the deutschemark would be revalued or other major currencies devalued. A flood of short-term funds poured into West Germany during the period preceding the 1969 parliamentary election. The 9.3% revaluation of the deutschemark that followed the election briefly reversed the flow. In 1970, however, West German short-term interest rates became substantially higher than those in

* The deutschemark was floated in May 1971, resulting in a **de facto** revaluation in terms of the US dollar of about 5% at the end of June and 12% in mid-December. The central rate set at the Washington Group of Ten meeting is 3.2225 deutschemarks to US $1, or a 13.6% revaluation from the pre-May parity.

West Germany: Foreign Economic Position **Figure 2**



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the US and Eurodollar markets, again attracting a massive inflow of funds. By the spring of 1971, the flow was augmented by a flood of speculative funds that led to the floating of the deutschemark in May.

20. West Germany's basic balance of current and long-term capital transactions has been in deficit since 1968. The overall balance of payments, however, was in substantial surplus in 1970 and again this year because of the large net inflows of short-term capital. As a result, Germany's gold and foreign exchange reserves rose from $8 billion at the beginning of 1969 to more than $17 billion in October 1971.

Problem Areas

21. In the current economic situation, Bonn faces a serious dilemma. Although monetary and fiscal restraints are still needed to fight inflation, stimulation of economic activity is increasingly required to forestall a recession. Proper timing of the transition to expansionary policies and selection of an appropriate policy mix clearly are crucial. Not desiring to interfere with market forces, the government has appealed to labor and management to hold the line on wages and prices. How effective this appeal will be remains to be seen. Despite the moderation shown in recent wage settlements, the union leadership seems unwilling to accept the government's wage guidelines, and the rank and file is becoming more militant.

22. Failure to bring labor into line would seriously jeopardize the effort to break the inflationary spiral, prevent the timely introduction of reflationary measures, and add to the government's political difficulties on the right and the left. The sharp rise in the cost of living has prompted increasingly strong partisan attack by the opposition Christian Democratic Union/Christian Social Union. It also threatens to alienate uncommitted voters whose support the government will need in the 1973 elections. In addition to threatening a full-fledged recession, maintenance of restrictive fiscal and monetary policies would further delay implementation of long-promised social and economic reforms – including improved housing, education, and medical facilities – expected by the Social Democratic Party (SPD) supporters.

23. Steering a proper course is particularly difficult because, unlike the situation in previous cyclical downswings such as in 1966-67, the government cannot count on export growth to compensate for declining domestic demand. The deutschemark's appreciation since May has impaired the competitive position of German industry – especially in the US and French markets, which together take more than 20% of German exports. In addition, recessionary tendencies are growing in most of Germany's principal foreign markets. The new parities agreed on at the Washington

Group of Ten meeting result in an average appreciation of the deutschemark of 6%-7% relative to all other currencies. With profit margins in many export industries already narrow, the impact on German exports could be substantial, although probably not in the next few months.

24. The machine building, automotive, electrical, iron and steel, and chemical industries are those most affected by revaluation. They are also the industries currently suffering most from lagging domestic investment demand. As shown by the following tabulation, all are highly dependent on exports:

	Exports as a Percent of Sales
Automotive products	3[illegible]
Machine building	35
Chemicals	31
Iron and steel	24
Electrical goods	22

These industries, which employ more than 40% of the industrial labor force, account for more than 40% of German sales of manufactured products and for nearly two-thirds of German exports.

Near-Term Prospects

25. The near-term outlook for the West German economy remains bleak despite the psychological lift expected from the recent currency settlement. Business confidence has been badly shaken by rising costs, declining orders, shrinking profit margins, and the generally unsettled state of the international monetary system. Widespread press predictions of impending recession have added to the general feeling of gloom. Labor militancy presents an increasing problem for management and has embarrassed the Brandt government. Indeed, unless labor abandons its opposition to the government's wage guidelines, it is unlikely that inflationary pressures will abate sufficiently to enable Bonn to implement its reflationary program soon.

26. The government and the leading economic research institutes recently predicted that, in the absence of stimulative measures, there would be a further sharp decline in the growth rate during the first half of 1972, followed by some recovery toward the end of the year. For 1972 as a whole, they project real economic growth at no more than 1%. Average

employment in 1972 is expected to decline by about 1% as a result of the slowdown, partly at the expense of foreign workers whose contracts are not renewed. Total unemployment is expected to reach perhaps 1.5% to 2% of the total number of wage and salary earners – roughly the level during the 1966-67 recession. These predictions should be little affected by the 18 December settlement.

27. Slackening domestic demand is expected to result in sharply reduced growth of imports. It will also encourage West German industry to intensify its export drive. But the combined influence of revaluation and of softened demand in Germany's major foreign markets nonetheless will reduce export growth, perhaps substantially. The decline of import growth in the next year or so probably will be more pronounced, however, and consequently the 1972 trade surplus should exceed that of 1971.

28. The economic slowdown currently predicted would be substantially moderated if greater labor restraint or overriding political considerations persuaded the government to begin pump-priming operations. Release of 5 billion deutschemarks ($1.6 billion at the new exchange rate) in federal and **Land** government countercyclical reserves and refund of the 5.8 biilion deutschemarks ($1.8 billion) in accumulated income tax surcharges would provide a strong stimulus for the economy.